Cytonn INVESTMENTS

Nairobi Metropolitan Area (NMA) Residential Report 2018/2019, & Cytonn Weekly #28/2019

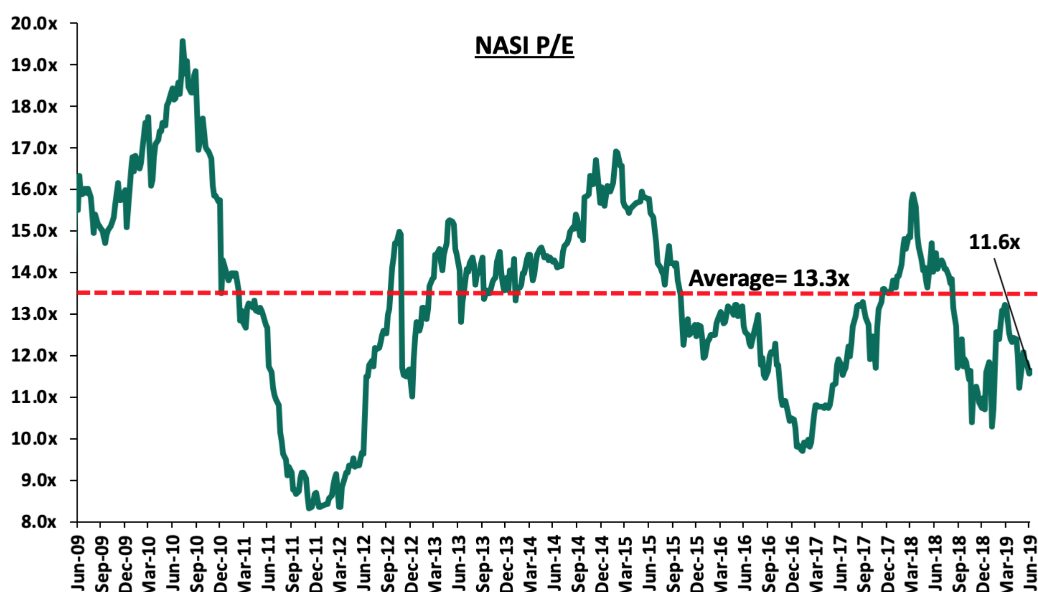
Equities

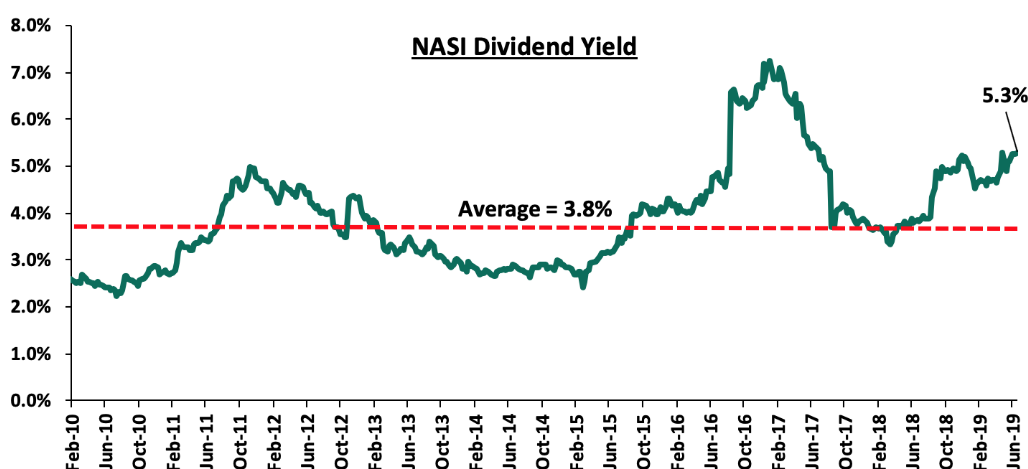
Market Performance

During the week, the equities markets had mixed performances with NASI remaining flat while NSE 20 and NSE 25 gained by 0.5% and 0.2%, respectively, taking their YTD performance to gains/(losses) of 6.5%, (5.5%) and 2.1%, for NASI, NSE 20 and NSE 25, respectively. The performance in NASI was driven by declines in KCB Group, Co-op Bank and Safaricom which declined by (1.9%), (1.2%) and (0.4%), respectively, which offset the gains made in East Africa Breweries Limited (EABL), Standard Chartered Bank Kenya (SCBK) and Equity Group, which recorded gains of 1.9%, 1.8% and 1.3%, respectively.

Equities turnover increased by 17.2% during the week to USD 24.4 mn, from USD 20.9 mn the previous week, taking the YTD turnover to USD 816.1 mn. Foreign investors remained net sellers for the week, with the net selling position increasing by 36.1% to USD 6.4 mn, from USD 4.7 mn the previous week.

The market is currently trading at a price to earnings ratio (P/E) of 11.6x, 13% below the historical average of 13.3x, and a dividend yield of 5.3%, 1.5% points above the historical average of 3.8%. With the market trading at valuations below the historical average, we believe there is value in the market. The current P/E valuation of 11.6x is 19.4% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 39.4% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.





Weekly Highlights

During the week, the Kenya Bankers Association (KBA) released the State of Banking Industry Report 2019. The report gives the various factors that shaped the banking sector's performance in 2018, the emerging trends, and the outlook for the sector going forward. The following are the key take-outs from the report:

i. The banking sector recorded a 9.8% growth in total assets, faster than the 6.8% growth recorded in 2017, aided by the relative recovery in the economy in 2018, from the harsh economic environment experienced in 2017 largely due to extended electioneering period. Growth was largely supported by increased allocations to government securities, as loans and advances recorded a relatively slower 1.9% growth in 2018, compared to the 4.0% growth recorded in 2017,
ii. Deposits continued to record relatively strong growth, as they grew by 10.7% in 2018, compared to the 9.7% growth recorded in 2017. The growth in deposits was largely supported by relative better economic performance in 2018, coupled with increased usage and penetration of mobile and agency banking. Tier 3 banks recorded the fastest growth in deposits, which came in at 33.0%, faster than tier 1 and tier 2 banks, which recorded growths of approximately 8.0% and 10.0% in 2018, from growths of approximately 10.6%, 9.0% 9.0%, for tier 1, tier 2 and tier 3 banks in 2017, respectively. This is indicative of improved confidence in tier 3 banks, from the negative perception of the banks that stemmed from the collapse of banks witnessed between 2015 and 2016,
iii. The relatively slower growth in loans, coupled with faster growth in deposits has led to a decline in the Loan to Deposit Ratio (LDR) to 74.0% in 2018, from 80.0% in 2017. The decline in lending

has largely been attributed to banks reallocating lending to the public sector, which offered better risk-adjusted returns than lending to the private sector. Reduced lending to the private sector has further been compounded by the asset quality deterioration over the last 3 years, with the Gross Non Performing Loans (NPL) ratio rising to 12.0% and 12.3% in 2018 and 2017, from 9.4% in 2016. Banks thus became relatively risk-averse and adopted relatively stringent credit policies to curb the rising NPLs, and consequently, avoid the associated provisioning expense,

iv. The relatively lower loans to deposit ratio points to the banking sector holding relatively higher liquidity, thus balancing the liquidity-profitability trade-off, given the reallocations to the more liquid, and relatively lower yielding government securities,

v. The banking sector remains relatively well buffered, with a core capital to risk-weighted asset ratio of 17.0% in 2018, an increase from 16.0% as at 2017, and 6.5% points above the minimum statutory requirement of 10.5%. Total capital to risk-weighted assets stood at 18.0%, a decline from 19.0% as at 2017, and 3.5% points above the minimum statutory requirement of 14.5%. The decline in total capital is presumably due to the implementation of the new IFRS 9 reporting standard from January 2018, which required banks to provide for both incurred credit losses and the expected credit losses. Banks were allowed to charge the incremental provisions arising from the implementation of the IFRS 9 standard on their balance sheets over a 5-year period from 2018. Furthermore, Loan Loss Provisions (LLP) increased by 11.7% in 2018, as a result of the implementation of IFRS 9,

vi. An improved operating environment led to an improvement in the financial performance, with total operating income growing by 3.3%, a recovery from the 4.8% decline recorded in 2017. Total operating expenses declined by 4.0%, from the 0.1% increase recorded in 2017. The decline in expenses has largely been aided by the various restructurings done by banks, which involved staff layoffs and branch closures. The shift in focus to alternative channels of transactions also helped reduce expenses, as they led to reduced staff and branch demands, and,

vii. In terms of funding costs, the industry cost of funds remained relatively flat, at approximately 2.2%, with the various tiers averaging 1.9%, 2.5% and 3.0%, for tier 1, tier 2 and tier 3, respectively. The relatively cheaper funding cost for the large banks is largely due to the economies of the scale enjoyed by the banks, as they have been able to successfully deploy the agency and mobile banking models, which enables them to cheaply mobilize funds. Furthermore, the banks have specialized lines of credit from international organizations and Development Finance Institutions (DFIs), in addition to having access to capital markets, which is not available for the small banks.

In summary, we note that the sector remains resilient, in the face of various challenges experienced, such as the current regime of capped interest rates. Given the bi-directional influence between the performance of the banking sector and the economy, the performance of the banking sector is shaped by the influences of the economic conditions, macroeconomic policies adopted, and the regulatory environment. Key regulations such as the Banking (Amendment) Act 2015 will continue to affect the sector’s performance, mainly affecting the funded income segment. With a proposal to repeal the law currently included in the Finance Bill 2019, we continue to expect an amendment of the law, possibly in the way of an increase in the margin from the current 4.0% above the Central Bank Rate (CBR). We also expect continued focus on alternative channels of transactions, which have the benefits of improving operating efficiency by growing Non-Funded Income (NFI) and reducing operating expenses. Under the current regime, we expect banks to continue exploring new revenue lines, largely by way of consolidations and strategic partnerships with Financial Technology (FinTech) and telecommunication companies. Consolidation would further help banks strengthen their deposit franchise, access niche segments, improve their pricing power in the market, provide cost benefits brought about by scale, shore up their capital bases, and consequently drive sustainable long-term growth.

During the week, KCB Group released the offer document for the intended 100% acquisition of the

National Bank of Kenya (NBK), and timelines for the acquisition. The expected timelines are as follows:

i. Both the Central Bank of Kenya (CBK) and the Competition Authority of Kenya (CAK) are expected to grant their approvals by 30thJuly 2019,
ii. The offer has a closing date of 30th August 2019,
iii. The settlement of the swap transaction, where the swap ratio will be 1 KCB share for 10 NBK shares, will be done on the 12th September 2019 with the listing of additional KCB shares set for 16th September 2019.

Details of the transaction are as follows:

i. The offer will be by way of a share swap at a ratio of 10:1, 10 ordinary shares of NBK for 1 ordinary share of KCB, whose shares are currently trading at Kshs 4.0 and Kshs 39.2, respectively as at 18th April 2019,
ii. NBK, which has both ordinary and preference shareholders, will have the preference shareholders convert their preference shares into new ordinary shares. The conversion ratio will be 1:1, i.e. 1 preference share for 1 ordinary share. With the number of preference shares at 1.13 bn, and the number of ordinary shares at 338.7 mn, this will imply a total of 1.47 bn ordinary shares post-conversion, and a dilution of 77.0% to the ordinary shareholders of NBK,
iii. Thus using the share swap ratio of 10:1, NBK's 1.47 bn ordinary shares will be swapped for 147.4 mn KCB shares,
iv. KCB will thus have to issue an additional 147.4 mn ordinary shares to complete the share swap. This will increase KCB's total shares outstanding to 3.21 bn shares from the current 3.06 bn shares, and current shareholders will be diluted by 4.6%,
v. The implied transaction value will, therefore, be Kshs 5.6 bn, being the offer of 147.4 mn KCB shares at a price of Kshs 38.0, which was the adjusted volume-weighted average share price for KCB Group for the period of 180 days to 16th April 2019, and,
vi. As at Q1'2019, NBK had a book value of Kshs 7.2 bn. As such the transaction is being carried out at a price-to-book value (P/Bv) of 0.8x, which is a 38.5% discount to the current listed banks trading book value of 1.3x, and 42.9% below the historical average P/Bv of 1.4x for the Kenyan Bank Transactions in the last 5 years;

The table below indicates previous banking acquisition deals and their transaction multiples in the Kenyan banking industry;

Mergers and Acquisitions in Kenya

Acquirer	Bank Acquired	Book Value at Acquisition (Kshs bns)	Transaction Stake	Transaction Value (Kshs bns)	P/Bv Multiple	Date
KCB Group	National Bank of Kenya	7.2	100.0%	5.6	0.8x	19-Apr*
CBA Group	Jamii Bora Bank	3.4	100.0%	1.4	0.4x	19-Jan*
AfricInvest Azure	Prime Bank	21.2	24.2%	5.1	1.0x	19-Jan
NIC Group	CBA Group	30.5**	47:53***	18.0	0.6x	19-Jan*
KCB Group	Imperial Bank	Unknown	Undisclosed	Undisclosed	N/A	18-Dec
SBM Bank Kenya	Chase Bank Ltd	Unknown	75.0%	Undisclosed	N/A	18-Aug

i. In our view, Kenya's banking sector consolidation will continue to happen and it will lead to a more stable, safer banking sector. Smaller banks constrained in capital, and struggling in their operations are likely to continue receiving take-over offers, which would present the best case scenario to navigate the current competitive banking sector landscape. Transactions are happening at significantly cheaper valuations, perhaps due to the smaller banks' relatively poor performance, leading to liquidity constraints, which may warrant even further capital injections, hence the cheaper acquisition costs. For more information on Banking Sector consolidation and Performance, see our Q1'2019 Kenya Listed Banking Report.

Universe of Coverage

Below is a summary of our SSA universe of coverage:

Banks	Price as at 05/07/2019	Price as at 12/07/2019	w/w change	YTD Change	Target Price	Dividend Yield	Upside/ Downside	P/TBv Multiple	Recommendation
Diamond Trust Bank	116.0	116	0.0%	(25.9%)	228.4	2.2%	96.2%	0.6x	Buy
CRDB	110.0	105.0	(4.5%)	(30.0%)	207.7	0.0%	88.8%	0.4x	Buy
UBA Bank	6.1	5.9	(2.5%)	(23.4%)	10.7	14.4%	87.0%	0.4x	Buy
Zenith Bank	19.3	19.0	(1.6%)	(17.6%)	33.3	14.2%	82.5%	0.8x	Buy
KCB Group***	40.0	39.3	(1.9%)	4.8%	60.4	8.9%	66.9%	1.0x	Buy
GCB Bank	4.9	5.0	0.2%	7.6%	7.7	7.7%	64.3%	1.2x	Buy
I&M Holdings	59.5	55.0	(7.6%)	29.4%	81.5	6.4%	54.5%	1.0x	Buy
Access Bank	6.6	6.7	1.5%	(1.5%)	9.5	6.0%	52.1%	0.4x	Buy
Co-operative Bank	12.3	12.1	(1.2%)	(15.4%)	17.1	8.3%	50.4%	1.0x	Buy
Equity Group	40.0	40.6	1.3%	16.4%	53.7	4.9%	42.7%	1.7x	Buy
NIC Group	30.3	30.5	0.8%	9.7%	42.5	3.3%	42.2%	0.6x	Buy
CAL Bank	1.0	1.0	(5.0%)	(3.1%)	1.4	0.0%	40.0%	0.8x	Buy
Barclays Bank	10.3	10.3	0.5%	(5.9%)	12.8	10.7%	33.1%	1.2x	Buy
Stanbic Bank Uganda	29.0	28.8	(0.6%)	(7.0%)	36.3	4.1%	29.1%	2.0x	Buy
SBM Holdings	5.5	5.6	0.7%	(6.7%)	6.6	5.4%	23.0%	0.8x	Buy
Guaranty Trust Bank	29.4	29.9	1.9%	(13.2%)	37.1	8.0%	20.8%	1.9x	Buy
Stanbic Holdings	100.0	100.0	0.0%	10.2%	113.6	5.9%	20.6%	1.1x	Buy
Ecobank	7.6	7.5	(0.7%)	0.0%	10.7	0.0%	19.2%	1.6x	Accumulate
Union Bank Plc	6.9	7.5	8.7%	33.9%	8.2	0.0%	16.4%	0.8x	Accumulate
Standard Chartered	194.0	198.0	1.9%	1.8%	200.6	6.3%	9.5%	1.4x	Hold
Bank of Kigali	274.0	275.0	0.4%	(8.3%)	299.9	5.0%	8.5%	1.5x	Hold
FBN Holdings	6.3	6.0	(4.0%)	(24.5%)	6.6	4.2%	5.4%	0.3x	Hold
Bank of Baroda	127.8	128.0	0.1%	(8.6%)	130.6	2.0%	3.4%	1.1x	Lighten
Standard Chartered	19.3	19.3	0.0%	(8.3%)	19.5	0.0%	2.3%	2.4x	Lighten
National Bank	4.1	4.1	(0.2%)	(23.1%)	3.9	0.0%	(4.8%)	0.2x	Sell
Stanbic IBTC Holdings	40.3	40.0	(0.6%)	(16.6%)	37.0	1.5%	(6.6%)	2.1x	Sell
Ecobank Transnational	9.9	10.0	0.5%	(41.5%)	9.3	0.0%	(15.6%)	0.4x	Sell
HF Group	4.0	4.3	7.0%	(22.6%)	2.9	0.0%	(27.7%)	0.2x	Sell

*Target Price as per Cytonn Analyst estimates
**Upside / (Downside) is adjusted for Dividend Yield
***Banks in which Cytonn and/or its affiliates are invested in
****Stock prices indicated in respective country currencies

We are "Positive" on equities for investors as the sustained price declines have seen the market P/E

decline to below its historical average. We expect increased market activity, and possibly increased inflows from foreign investors, as they take advantage of the attractive valuations to support the positive performance.

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